ECONOMICS

Economic Assumptions

The Chairman's Mark baseline is built upon CBO's latest multi-year economic assumptions. CBO compiles economic forecasts for 1998 and 1999, which reflect the current state of the economy and relative position in the business cycle. CBO's out year projections are based upon longer-term trends in the economy.

Overview

The economy was exceptionally strong in 1997 -- real GDP grew by 3.8 percent while the unemployment rate dropped to 4.7 percent by year-end. Despite above-trend growth, inflation fell slightly from its 1996 pace. This performance is even more noteworthy, given the fact that it occurred seven years into the present expansion. The more favorable economic backdrop accounts for roughly one third of the drop in the FY 1999-2003 cumulative deficit from CBO's September baseline to their March 1998 estimate.

Looking ahead there are an unusual number of uncertainties on the horizon, most notably the fall out from the Asian financial crisis. When coupled with the maturity of the current expansion, the present economic backdrop argues for caution in preparing budget estimates. This caution is reflected in the CBO economic assumptions used to prepare the Chairman's Mark.

Comparison of Administration Economics Versus CBO's

OMB's and CBO's economic forecasts are similar overall and are within the range of error on these forecasts. OMB is slightly more optimistic on inflation and income shares. CBO is slightly more optimistic on the level of nominal GDP.

Growth. OMB and CBO look for the economy to slow from 1997's torrid pace. Both expect below-trend real growth over much of the 1999-2003 budget window, induced in part by the spillover effects of the Asian crisis on US net exports. Yet, OMB believes more of the slowdown will occur in 1998 and the early part of the budget window, while CBO expects the slowdown to be more weighted toward the latter part. OMB expects average annualized real GDP growth of 2.2 percent during the budget window, while CBO expects 2.1 percent growth. However, CBO assumes slightly faster nominal GDP growth.

Inflation. OMB has lower CPI and GDP deflator forecasts than does CBO. While inflation was very subdued in 1997, CBO believes that this is the result of a series of temporary factors -- namely, lower import prices due to the strong dollar, sharp declines in computer prices and slower growth of medical costs. As these factors fade, CBO expects CPI growth to pick up.

In contrast, OMB looks for inflation to stay low due to continued dollar strength and the likelihood that firms will absorb some price increases given their wide profit margins.

These CPI differences arise solely from variations in the underlying economic assumptions. Both OMB and CBO assume that ongoing technical changes by the BLS will shave roughly 0.4 percentage points from CPI growth during the budget window. Largely, these adjustments were previously incorporated into the Bipartisan Budget Agreement baselines of last year, and continued this year.

The spread between CPI and the GDP deflator also matters for budget projections. Since indexed outlays are linked mainly to CPI while revenue projections are based on the GDP deflator, budget forecasts look better the lower CPI is in relation to the GDP deflator. OMB expects a lower spread than CBO.

Income Shares. Income shares depict the breakdown of national income between wages and salaries, benefits, corporate profits, proprietors' income, rental income and net interest. They are expressed as a share of GDP. Wages and salaries and corporate profits are taxed at a higher effective rate -- the higher they are compared with the other income categories, the higher the projected revenue stream.

Unlike last year, differences in wages and salaries and profit shares have relatively little budgetary effect -- while the sum of OMB's wage and salary and corporate profit shares are higher, this is largely offset by CBO's higher nominal GDP forecasts.

Revenue Strength

In the last four years, revenue growth has outstripped GDP growth by more than 2 percent, boosting the ratio of federal revenues to GDP to a post-1945 record of 19.8 percent.

1997 revenue growth was particularly strong, with actual revenues roughly $70 billion above both CBO's and OMB's January 1997 projections. According to CBO's analysis, 85 percent of this $70 billion was accounted for by higher than expected individual income tax receipts. The strength in 1997 individual income tax receipts likely derived from three sources: (1) stronger than expected growth in personal income due to the robust economy, (2) unusually high capital gains realizations, and (3) a rise in the effective tax rate. The latter two factors caused individual receipts to rise at twice the rate as personal income growth.

Based on continued economic strength and the likely persistence of some technical factors, both CBO and OMB largely extrapolated FY 1997's revenue strength into FY 1998 and FY 1999. Beyond FY 1999, both made at least partial extrapolation of the final FY 1997 outcome. CBO's and OMB's current services revenue projections are now essentially identical.

Sensitivity to Economic Changes

Last year's experience showed the sensitivity of the deficit to economic and technical changes. While 1997's outcome was favorable, it could just as easily have been a negative surprise. CBO notes that seeing a 2 percent swing in any one year from projections of both revenue and outlays is not uncommon. Should revenues fall short by 2 percent and outlays run ahead by the same amount, this could produce a $60 billion increase in the deficit.

The onset of recession would have an even larger effect. CBO notes that a "typical" recession could increase the deficit by more than $100 billion. While no one expects a near-term US recession, a further worsening of the Asian crisis could bring such fears into view.

Remembering the maturity of the current economic expansion is also important. Now into its eighth year, it will be the longest peacetime expansion if it lasts until the end of 1998. If it lasts until the end of the budget window, it will be the longest expansion on record. CBO attempts to account for recession risks by having the economy operate at slightly below its level of potential GDP in the out years. Yet, should a recession hit within the five-year budget window, budget outcomes would be much worse than current estimates. This argues for cautious FY 1999 budgeting.

Long-Term Outlook

CBO's long-term fiscal analysis shows that the Bipartisan Budget Agreement has improved the long-term outlook. Yet, it does not prevent an eventual explosion in our debt/GNP ratio once the baby-boomers' retirement costs mount early in the next century. To solve the US' long-term fiscal problems, CBO finds that the government would need to cut either spending or raise taxes by 1.6 percent of GDP permanently.

CBO's projections may well err on the optimistic side. CBO uses population projections formulated by the Social Security Administration. The Advisory Council on Social Security and many private demographers believe that median life expectancies have increased more than SSA assumes, which would worsen CBO's long-term fiscal projections. Thus, the Chairman's Mark does not assume spending or reductions in taxes from any near-term projected surplus. Instead, the near-term reprieve in fiscal outlook is an opportunity to undertake meaningful dialogue and reform of entitlement programs like Medicare and Social Security. Only through such action, will there be a truly favorable fiscal outlook overall.